I. INTRODUCTION

The quality of management is probably the single most important element in the successful operation of a bank. For purposes of this section, "management" includes both the board of directors, which is elected by the shareholders, and executive officers, who are appointed to their positions by the board. In the complex, competitive and rapidly changing environment of financial institutions, it is extremely important for all members of bank management to be aware of the responsibilities entrusted to them and discharge those responsibilities in a manner which will ensure stability and soundness of the institution, so that it may continue to provide its community the financial services for which it was created.

The extreme importance of a bank director's position is clearly emphasized by the fact that bank directors can, in certain instances, be held personally liable. Also, Congress has placed great emphasis on the role of bank management by passing legislation which allows regulatory authorities to utilize "cease and desist" actions against individuals (instead of solely against the institution), to assess civil money penalties, and even remove an officer, director, or other person participating in the affairs of the bank when their gross negligence or disregard for safety and soundness considerations threatens the financial safety of the bank.

The board of directors is the source of all authority and responsibility. In the broadest sense, the board is responsible for formulation of sound policies and objectives of the bank, effective supervision of its affairs, and promotion of its welfare. On the other hand, the primary responsibility of executive management is implementation of the board's policies and objectives in the bank's day-to-day operations. While selection of competent executive management is critical to the successful operation of any bank, the continuing health, viability and vigor of the bank are dependent upon an interested, informed and vigilant board of directors. Therefore, the main thrust of this section is devoted to the powers, responsibilities and duties vested in bank directors.

II. DIRECTORS

Selection and Qualifications of Directors

Being selected to serve as a bank director is generally regarded as an honor, for it often denotes an individual's reputation as being successful in business or professional endeavors, public spirited, and entitled to public trust and confidence. It is this latter attribute and the public accountability implicit therein that distinguishes the office of bank director from directorships in most other corporate enterprises. Bank directors are not only responsible to the stockholders who elected them, but must also be concerned with the safety of depositors' funds and the pervasive influence the bank exercises on the community it serves.

The importance of a director's position is emphasized by various laws governing the election of board members. Statutory or regulatory qualifications usually include taking of an oath of office, unencumbered ownership of a specific amount of the bank's capital stock, and residential and citizenship requirements. Other laws also pertain to qualification and selection of directors. There are, for example, certain restrictions, prohibitions, and penalties relating to: interlocking directorates; purchases of assets from or sales of assets to directors; commissions and gifts for procuring loans; and criminal activities such as embezzlement, abstraction, willful misapplication, making false entries, and improper political contributions. These qualifications and restrictions have no counterpart in general corporate law and both illustrate and emphasize the quasi- public nature of banking, the unique role of the bank director, and the grave responsibilities of that office. The position of bank director is one, therefore, not to be offered or entered into lightly.

Aside from the legal qualifications, each director should bring to the position particular skills and experience which will contribute to the composite judgment of the group. Directors should have ideas of their own and the courage to express them, sufficient time available to fulfill their responsibilities, and be free of financial difficulties which might tend to embarrass the bank. The one fundamental and essential attribute which all bank directors must possess without exception is personal integrity. Its presence usually gives assurance of a well-intentioned, interested and responsible director capable of assuming the important fiduciary responsibilities of the office and representing fairly and equitably the diverse interests of stockholders, depositors and the general public. Other desirable personal characteristics include: knowledge of the duties and responsibilities of the office; genuine interest in performing those duties and responsibilities to the best of their ability; capability of recognizing and avoiding potential conflicts of interest, or the appearance of same, which might impair their objectivity; sound business judgment and experience to facilitate understanding of banking and banking problems; familiarity with the community and trade area the bank serves and economic conditions generally; and an independence in their approach to problem solving and decision making.

Powers, Duties and Responsibilities of Directors

The powers, duties and responsibilities of the board of directors are usually set forth in the applicable banking statutes and the bank's charter and bylaws. Generally speaking, the powers and responsibilities of bank directors include but are not limited to those discussed below.

• Regulating the Manner in Which All Business of the Bank is Conducted

Directors must provide a clear framework of objectives and policies within which executive officers must operate and administer the bank's affairs. These objectives and policies should, as a minimum, cover investments; loans; asset, liability and funds management; profit planning and budgeting; capital planning; internal routine and controls; and personnel. Objectives and policies in most instances should be reduced to written form and reviewed on a periodic basis to determine that they remain applicable to the present operating environment. Examiners may encounter situations (often in smaller banks with control vested in one or a few individuals) where written policies have not been developed for these operational functions, and management is reluctant to do so on the grounds that such written guidelines are unnecessary. To a considerable degree, the necessity for written policies may be inferred from the results achieved by management. That is, if the examiner's assessment of the bank reflects it is sound and healthy in virtually every important respect, it may be difficult to convince management of the need for formalized written policies. However, when deficiencies are noted in one or more aspects of a bank's operations, it is nearly always the case that absence of written and clearly defined objectives, goals, performance standards, and limits of authority is an important contributing factor. There are few better means of ensuring that directors are properly supervising the bank's affairs than by their direct participation in devising, enforcing, and modifying the institution's written guidelines on such matters as investments, loans, marketing, capital and profit planning. Moreover, it is recognized that the depth and detail of written policies may properly vary among banks, depending on the nature, scope and complexity of their operations. Therefore, it remains the FDIC's strongly held belief that all banks should have written policies which are readily understood by all affected parties, kept up-to-date, and relevant to the institution's needs and circumstances. While it is acceptable for a bank to obtain written policies from an outside source, it is the responsibility of management to ensure that the policies are suited to their bank and that the policies accurately describe the bank's practices. Final approval of the substantial content of policies should be given by the board of directors.

• Corporate Planning

A vital part of the responsibilities of directors is to set the future direction of the bank. Planning, organizing, and controlling are three fundamental dimensions of management. Planning, however, had not been a priority concern for a large part of the banking industry. This may have been due in part to the fact that the industry has historically been highly regulated and somewhat insulated from competitive pressures and sudden change. Dramatic changes in the structure, volatility and technology associated with the financial services market altered this situation and led to an emphasis on deregulating financial institutions. Increased competition and innovation consequently produced an environment characterized by uncertainty.

Sound planning is indispensable in dealing with this uncertainty and rapid change. In order to be effective, planning must be dynamic, carefully attended to, and well- supported. Projections

must be revised periodically as circumstances change and new strategies devised to meet stated objectives. An increasingly competitive marketplace suggests that an inadequate or ill-conceived planning process may be as much the cause of bank failure as poor loans.

A comment on the bank's planning process must be provided in the Administration, Supervision, and Control schedule in the examination report. The adequacy of a bank's planning process may be judged by considering questions such as:

1. **How formal is the bank's planning process?**

2. **Who is involved? The board? Middle management?**

3. **Is the plan based on realistic assumptions regarding the bank's present and future market area(s) and nontraditional competitive factors?**

4. **Does the bank monitor actual performance against its plan?**

5. **Does the bank consider alternative plans in response to changing conditions?**

Although the focus must be on an evaluation of the process, the plan itself cannot be ignored if in the examiner's judgment the plan is predicated on assumptions which are believed to be altogether inappropriate or unrealistic. This assessment must carefully take into account the personnel and financial resources and operating circumstances and conditions unique to the bank being examined. It is emphasized that plotting the future direction of the institution is, properly, the prerogative and responsibility of the board of directors and not examiners. However, when the goals and objectives chosen by directors are likely to result in significant financial harm to the bank, examiners would be remiss were they not to identify the deficiencies in the plan and attempt to effect necessary changes.

Absence of a satisfactory planning process or glaring weaknesses in the plan itself must be considered in the appraisal of bank management. Comments in the Management/Administration schedule of the report of examination may be appropriate.

● Appointing, Dismissing at Pleasure, and Defining the Duties of Officers

It is a primary duty of a board of directors to select and appoint executive officers who are qualified to administer the bank's affairs effectively and soundly. It is also the responsibility of the board to dispense with the services of officers who prove unable to meet reasonable standards of executive ability and efficiency.

● Personnel Administration

A bank's recruiting, training, and personnel activities are vital to the development and continuity of a quality staff. Some features of good personnel administration are a designated organization structure, detailed position descriptions, carefully planned recruiting, appropriate training and developmental activities, a performance appraisal system, quality salary administration, and an effective communications network.

● Honestly and Diligently Administering the Affairs of the Bank

The board of directors is charged with the responsibility of the conduct of the affairs of the bank. It is not expected to directly carry out details of the bank's business; these may be delegated to the bank's officers. But they may not be delegated and forgotten. The power to manage and administer carries with it the duty to supervise, therefore, directors must periodically examine the system of administration they have established to see that it functions properly. Should it become obsolete, it should be modernized, or should the bank's officers fail to function as intended, the cause(s) should be determined and corrections made.

● Observance of Laws to Which the Bank is Subject

It is of utmost importance for directors to ensure that executive management is cognizant of applicable laws and regulations; develop a system to effect and monitor compliance, which will likely include provisions for training and retraining personnel in these matters; and, when violations do occur, make correction as quickly as possible. Board members cannot be expected to be

personally knowledgeable of all laws and regulations, but it is a duty inherent with their office to make certain that compliance with all laws and regulations receives high priority and violations are not knowingly committed by themselves or anyone in the bank's employ.

● Avoiding Self-Serving Practices

Although somewhat independent from the responsibility to provide effective direction and supervision, the need for directors to avoid self-serving practices and conflicts of interest is of no less importance. Bank directors must act so as to place performance of their duties above personal concerns. Wherever there is a personal interest of a director which is adverse to that of the bank, the situation clearly calls for the utmost fairness and good faith in guarding the interests of the bank. Accordingly, directors must never abuse for personal advantage their influence with respect to the bank's management, nor wrongfully employ confidential information concerning the bank's clients. The same principles with respect to self- serving practices and conflicts of interest apply to the executive management of the bank.

● Paying Such Dividends as May Properly Be Paid

The board of directors has the responsibility of maintaining an adequately capitalized bank, and once this responsibility has been satisfied, the payment of dividends can and should receive consideration. Dividends represent the distribution of bank earnings to owners. Establishing the medium, rate, and date of payment must be based on the directors' overall assessment of the bank's financial condition.

● Appropriate Internal Control System and Adequate Auditing Program

These are the responsibility of the board of directors. Refer to the Internal Routines and Controls Section for a complete discussion of these vital areas.

● Management Information System (MIS)

The critical need for and dependence on information involves a concern and responsibility for the integrity of not only the specific information furnished, but the system that supplies it as well. Advances in technology have helped banks improve both information availability and models for analysis and decision making. Regardless of the technology employed, management is responsible for developing and implementing an information system which facilitates managerial activities. Review of these reports should be undertaken during onsite examinations to ascertain the accuracy of the information being provided.

An effective MIS is comprised of information from a number of sources, and the information must serve a number of users, each having various needs. The MIS must selectively update information and coordinate it into meaningful and clear formats. One possible approach would be to combine information from the bank's accounting system with other internal sources, such as personnel records, and include information from external sources regarding economic conditions, characteristics of the marketplace and competition, technology, and legal regulatory requirements. Quality, quantity and timeliness are factors which determine the effectiveness of management information systems.

Supervision by Directors

Supervision by directors does not necessarily indicate a board should be performing management tasks, but rather seeing that its policies are being implemented and adhered to and its objectives achieved. It is the failure to discharge these supervisory duties which has led to bank failures and personal liability of directors for losses incurred.

Directors' supervisory responsibilities can best be discharged by establishing procedures calculated to bring to their attention relevant and accurate information about the bank in a consistent format and at regular intervals. From this critical point, the remainder of a director's job unfolds. Directors who keep abreast of basic facts and statistics such as resource growth, capital growth, loan-to-deposit ratios, deposit mix, liquidity position, general portfolio composition, loan limits, loan losses and recoveries, delinquencies, etc., have taken a first, indispensable step in discharging their responsibilities. It is essential, therefore, that directors insist on receiving pertinent information about the bank in concise, meaningful and written form, and it is one of

executive management's most important responsibilities to make certain directors are kept fully informed on all important matters and that the record clearly reflects this.

Directors' meetings which are conducted in a businesslike and orderly manner are a significant aid to fulfillment of the board's supervisory responsibilities. This requires, among other things, regularity in attendance. Physical presence is obviously necessary because absence without just cause is, like ignorance, not a valid defense. Moreover, a director's attendance should be an informed and intelligent one, and the record should show it. If directors dissent from the majority, they should, for their own protection, insist upon their negative vote being recorded along with reasons for their action.

Careful and consistent preparation of an agenda for each directors' meeting not only assists in the conduct of such meetings, but also provides board members reasonable assurance that all important matters are brought to their attention. Agenda items will vary from bank to bank depending on asset size, type of business conducted, loan volume, trust activities and so forth. In general, the agenda should include reports on income and expense; new, overdue, renewed, insider, charged-off and recovered loans; investment activity; personnel; and individual committee actions.

To carry out its functions, the board of directors may appoint and authorize committees to perform specific tasks and supervise certain phases of operations. In most instances, the name of the committee, such as loan, investment, examination, and, if applicable, trust, identifies its duties. Of course, utilization of the committee process does not relieve the board of its fundamental responsibilities for actions taken by those groups. Review of the minutes of these committees' meetings should be a standard part of the board meeting agenda.

Communication of facts to a bank's board of directors is essential to sound and effective supervision. However, with the ever-broadening scope of modern banking and the increased complexity of banking operations, the ability of a board of directors to effectively supervise is becoming more difficult. Because of this, the use of outside personnel to provide management supervision is relatively common. While this does not release the board from its legal and implied responsibilities, it does provide an opportunity for management improvement through the use of these external sources. Since the early 1970's, the bank holding company has played a very large role in the supervision of its individual banks. Bank holding companies which control a number of banks may be able to provide individual banks' boards with lending and investment counseling, audit and internal control programs or services, profit planning and forecasting, personnel efficiency reports, electronic data processing services, marketing strategy and asset appraisal reports. Banks which do not operate within a holding company organization are also able to obtain management assistance from various firms offering the above services. In the interest of quality supervision by a bank's board of directors, the use of outside advisors, while not releasing the board from its responsibilities, can be a valuable management tool.

Legal Liabilities of Directors

In general, directors and other corporate officers of a bank may be held personally liable for: a breach of trust; negligence which is the proximate cause of loss to the bank; ultra vires acts, or acts in excess of their powers; fraud; and misappropriation or conversion of the bank's assets. From the standpoint of imposing directors' liability where the facts evidence that fraud, misappropriation, conversion, breach of trust or commission of ultra vires acts is clearly shown, a relatively simple situation presents itself. Difficulties usually arise, however, in cases involving negligence (or breach of duty) which fall short of breach of trust or fraud.

Directors' liability for negligent acts is premised on common law for failure to exercise the degree of care prudent individuals would exercise under similar circumstances, and/or noncompliance with applicable statutory law, either or both of which proximately cause loss or injury to the bank. Statutory liability is reasonably well-defined and precise. Common law liability is somewhat imprecise since failure to exercise due care on the part of a director depends on the facts and circumstances of the particular case.

A director's duty to exercise due care and diligence extends to the management,

administration and supervision of the affairs of the bank and to the use and preservation of its assets. Perhaps the most common dereliction of duty by bank directors is the failure to maintain reasonable supervision over the activities and affairs of the bank, its officers and employees. The actions and inactions listed below have been found to constitute negligence on the part of directors.

1. **An attitude of general indifference to the affairs of the bank, such as failing to hold meetings as required by the bylaws, obtain a statement of the financial condition of the bank, or examine and audit the books and records of the bank to determine its condition.**

2. **Failure to heed warnings of mismanagement or defalcations by officers and employees and take appropriate action.**

3. **Failure to adopt practices and follow procedures generally expected of bank directors.**

4. **Turning over virtually unsupervised control of the bank to officers and employees in reliance upon their supposed fidelity and skill.**

5. **Failure to acquaint themselves with examination reports showing the financial condition of a company to which excessive loans had been made.**

6. **Assenting to loans in excess of applicable statutory limitations.**

7. **Permitting large overdrafts in violation of bank's bylaws or permitting overdrafts to insiders in violation of law.**

8. **Representing certain assets as good in a report of condition when such assets were called to the directors' attention as loss by the primary supervisor and directions were given for their immediate collection or removal from the bank.**

In the final analysis, liability of bank directors for acts of negligence rests upon their betrayal of those who placed trust and confidence in them to perform honestly, diligently and carefully the duties of their office. While applicable principles involving directors' negligence (or breach of duty) are easy enough to state, their application to factual situations presents difficulties. In essence, the courts have judged the conduct of directors "not by the event, but by the circumstance under which they acted" (Briggs v. Spaulding, 141 U.S. 132, 155(1890), 35L.Ed. 662, 672). Courts also have generally followed what may be called the rule of reason in imposing liability on bank directors, "lest they should, by severity in their rulings, make directorships repulsive to the class of men whose services are most needed; or, by laxity in dealing with glaring negligences, render worthless the supervision of director's over...banks and leave these institutions a prey to dishonest executive officers" (Robinson v. Hall, 63 Fed. 222,225-226(4th Cir. 1894)).

The following quotation represents a brief recapitulation of the law on the subject (Rankin v. Cooper, 149 Fed. 1010, 1013 (C.C.W.D. Ark. 1907):

> **"(1) Directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. (2) They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank, and they are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors. (3) Ordinary care in this matter as in other departments of the law, means that degree of care which ordinarily prudent and diligent men would exercise under similar circumstances. (4) The degree of care required further depends upon the subject to which it is to be applied and in each case must be determined in view of all circumstances. (5) If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, upon the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is**

required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. (6) Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. (7) It is incumbent upon bank directors in the exercise of ordinary prudence, and as a part of their duty of general supervision, to cause an examination of the condition and resource of the bank to be made with reasonable frequency."

III. FEDERAL BANKING LAWS AND REGULATIONS PRIMARILY PERTAINING TO BANK DIRECTORS

Section 18(k) of the FDI Act Golden Parachutes and Indemnification Payments

Permits the FDIC to prohibit or limit, by regulation or order, any golden parachute payment or indemnification payment.

Section 32 of the FDI Act Agency Disapproval of Directors and Senior Executive Officers of Insured Depository Institutions or Depository Institution Holding Companies

A troubled insured depository institution or troubled depository institution holding company may not add any individual to the board of directors or employ any individual as a senior executive officer if the appropriate Federal banking agency issues a notice of disapproval of such addition or employment before the end of the 30-day period beginning on the date the agency receives the required notice.

Section 19 of the FDI Act - Criminal Offense Involving Dishonesty or Breach of Trust

Section 19 of the Federal Deposit Insurance Act provides that, except with the written consent of the FDIC, no person shall serve as a director, officer, or employee of an insured bank who has been convicted of any criminal offense involving dishonesty or breach of trust. The FDIC does not view Section 19 as being punitive in intent. Rather, the essential criterion in assessing applications is whether the prospective director, officer or employee constitutes a significant threat or risk to the safety and soundness of the applicant bank. The FDIC's policy is to approve applications in which this risk is absent.

Part 349 of the Federal Deposit Insurance Corporation Rules and Regulations

Implements Title VIII of the Financial Institution Regulatory and Interest Rate Control Act of 1978 (FIRIRCA). Title VIII prohibits (1) preferential lending by a bank to executive officers, directors, principal shareholders of another bank, or any related interest of such person, when there is a correspondent account relationship between the banks; or (2) the opening of a correspondent account relationship between banks when there is a preferential extension of credit by one of the banks to an executive officer, director or principal shareholders of the other bank, or any related interest of such person. Title VIII also imposes reporting requirements with respect to certain insiders.

Section 22(g) and 22(h) of the Federal Reserve Act

Sections 22(g) and 22(h) are incorporated into the FDI Act via section 18(j)(2) and pertains to loans and extensions of credit by both member and nonmember banks to their executive officers, directors, principal shareholders and their related interests (Section 18(j)(2) does not apply to any foreign bank in the United States but does apply to the insured branch itself). It is a very important statute in the examination and supervisory process because it is aimed at prevention and detection of insider abuse, a common characteristic of failed or failing banks.

Part 215 of Federal Reserve Regulation 0 implements Section 22(h) and requires that extensions of credit to executive officers, directors, principal shareholders or their related interests be made on substantially the same terms as those prevailing at the time for comparable transactions with persons not covered by the regulation. Aggregate lending limits are also imposed by Regulation O and apply to executive officers, directors, principal shareholders and their related interests. Moreover, payment of overdrafts of directors or executive officers is prohibited unless part of a written, preauthorized interest-bearing, extension of credit plan. The requirements, prohibitions and restrictions of Regulation 0 are important and examiners should be fully familiar with them. The complete text of the regulation is contained in the Prentice-Hall volumes.

Section 337.3 of FDIC Rules and Regulations sets forth requirements for approval of extensions of credit to insiders. Specifically, prior approval of the bank's board of directors is necessary if an extension of credit or line of credit to any of the bank's executive officers, directors, principal shareholders, or to any related interest of any such person, exceeds the amount specified in the regulation when aggregated with the amount of all other extensions of credit or lines of credit to that person. This approval must be granted by a majority of the bank's directors and the interested party(ies) must abstain from participating directly or indirectly in the voting.

Any nonmember insured bank which violates or any officer, director, employee, agent or other person participating in the conduct of the affairs of a nonmember insured bank who violates any provision of Section 22(g) or 22(h) of the Federal Reserve Act may be subject to a civil penalty. In determining the amount of the penalty, the FDIC takes into account the financial resources and good faith of the bank or person charged, gravity of the violation, history if any of previous violations, and such other matters as justice may require. Examiners are reminded violations of Regulation 0 must be evaluated in accordance with the 13 factors specified in the interagency policy statement on assessment of civil money penalties.

Depository Institution Management Interlocks Act - (Part 348 of the FDIC Rules and Regulations)

This act is contained in 12 U.S.C. 1823(k) and has as its general purpose the fostering of competition. It prohibits a management official of one depository institution or depository holding company from also serving in a similar function in another depository institution or depository holding company if the two organizations are not affiliated and are located in the same area or if the two organizations are not affiliated and are very large.

A person whose interlocking service in a position as a management official of two or more depository organizations began prior to November 10, 1978, and who was not immediately prior to that date in violation of Section 8 of the Clayton Act (15 U.S.C. Section 19), is not prohibited from continuing to serve in such interlocking positions until November 10, 1993, except for certain exceptions explained in the regulation. A number of other exceptions allowing interlocking relationships for certain organizations and their affiliates are detailed in Part 348 of the Rules and Regulations. Under Section 8(e) of the FDI Act, the FDIC may serve written notice of intention to remove a director or officer from office whenever, in its opinion, such director or officer of an insured bank has violated the Depository Institution Management Interlocks Act.

Securities Brokers

With certain exceptions, Section 78 of Title 12, U.S.C., provides that no officer, director, or employee of any corporation or unincorporated association, nor partner or employee of any partnership, and no individual employed or engaged in the general brokerage business shall serve at the same time as an officer, director, or employee of a bank which is a member of the Federal Reserve System. This prohibition does not apply to nonmember banks. Nevertheless, in applications for Federal deposit insurance which contemplate that securities brokers will be serving as bank directors, the FDIC generally requires written assurances that a separation of the roles of broker and bank director will be maintained. To preclude the possibility of improprieties or conflicts of interest, such assurances may also be required to securities brokers who are elected directors of operating banks.

Change in Bank Control Act of 1978

Section 7(j) of the Federal Deposit Insurance Act prohibits any person, acting directly or indirectly or through or in concert with one or more other persons, from acquiring control of any insured bank through a purchase, assignment, transfer, pledge, or other disposition of voting stock of the insured bank unless the appropriate Federal banking agency has been given sixty days' prior written notice of the proposed acquisition. An acquisition may be made prior to the expiration of the disapproval period if the agency issues written notice of its intent not to disapprove the action. The term "insured bank" includes any bank holding company which has control of any insured bank, and the appropriate Federal banking agency in the case of bank holding companies is the Board of Governors of the Federal Reserve System. The term "control" is defined as the power, directly or indirectly, to direct the management or policies of an insured bank or to vote 25% or more of any class of voting securities of an insured bank. Willful violations of this statute are subject to civil money penalties of up to $10,000 per day. As was the case with respect to Section 22(h), this statute gives the FDIC important supervisory powers to prevent or minimize the adverse consequences that almost invariably occur when incompetent or dishonest individuals obtain positions of authority and influence in banks.

IV. OTHER ISSUES

Indebtedness of Directors, Officers and Their Interests

The position of director or officer gives no license to special credit advantages or increased borrowing privileges. Loans to directors, officers and their interests must be made on substantially the same terms as those prevailing at the time for comparable transactions with regular bank customers. Therefore, management loans should be evaluated on their own merits. They should not be adversely classified merely because they are management loans. On the contrary, a bank directorate is often composed of the most reputable and creditworthy individuals in the community. Their business operations will, in many instances, necessitate bank loans, and these will ordinarily be among a bank's better assets. Since directors usually maintain a deposit relationship with their bank, this carries with it an obligation to meet their reasonable and prudent credit requirements.

On the other hand, there have been many instances where improper loans to officers, directors, and their interests resulted in serious losses. Unfortunately, when the soundness of a management loan becomes questionable, an embarrassing situation usually results. That is, management loans frequently may not be subject to the same frank discussion accorded other loans. Bank directors may assent to such loans, despite knowledge that they are unwarranted, rather than oppose a personal or business friend or associate. Moreover, directors who serve on the board in order to increase their opportunities for obtaining bank credit are reluctant to object to credit extensions to their colleagues. Problems that occur with management loans have received considerable legislative attention and laws have been passed to curb abuses associated with the position of director or officer (e.g., Regulation 0). However, while steps have been taken to reduce the potential for problems in this area, a review of the board's policies and actual practices regarding insider loans remains an intricate part of the examination process.

Conflicts of Interest

Examiners should be especially alert to any insider involvement in real estate projects, loans or other business activities that pose or could pose a conflict of interest with their fiduciary duties of care and loyalty to the bank. On occasion, loans are advanced to business associates involved in ostensibly unrelated projects where an insider nevertheless benefited. The involvement of bank insiders in these projects is sometimes not apparent since ownership is held in the form of "business trusts" or other entities without disclosure of the identity or personal guarantees of the principals. In order to help uncover these types of situations, examiners should routinely inquire of senior management, through incorporation in the "first day" letter or request, whether any of the following situations exist:

1. Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of the bank holds a beneficial interest.

2. Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) of another depository institution holds a beneficial interest.

3. Loans or other transactions at any depository institution in which a bank officer, director, or principal stockholder (or

immediate family member of each) holds a beneficial interest, either direct or indirect.

4. Loans or other transactions in which an officer, director or principal stockholder (or immediate family member of each) has no direct interest but which involve parties with whom an insider has other partnership or business association.

5. Loans extended personally by officers, directors or principal stockholders (or immediate family member of each) to parties who are also borrowers from the bank or loans extended personally by any borrowing customers to an officer, director or principal stockholder of the bank.

If any of this information is not readily available, management should be requested to survey their officers, directors and principal stockholders as necessary to obtain it.

Examiners are also reminded to inquire into bank policies and procedures designed to bring conflicts of interest to the attention of the board of directors when they are asked to approve loans or other transactions in which an officer, director or principal stockholder may be involved. Where such policies and procedures are lacking or insufficient to reveal insider involvement before action is taken by the board, the bank should be strongly encouraged to remedy the deficiency. The board should also be encouraged to act specifically on any loan or other transaction in which insiders or their associates may be involved, either directly or indirectly or because of business associations outside the loan or transaction in question. Moreover, the results of board deliberations on any matter involving a potential conflict of interest should be noted clearly in the minutes.

Examiners are also reminded to carefully scrutinize any loan or other transaction in which an officer, director or principal stockholder is involved. Such loans or other transactions should be sound in every respect and be in full compliance with applicable laws and regulations and the bank's own policies. Any deficiencies in credit quality or other aspects of the transaction should receive critical comment not only from an asset quality perspective but from a management perspective as well. More specifically, if a director has a personal financial interest in a loan or other transaction subject to adverse classification, the board should be urged to require that director to strengthen the credit sufficiently to remove the adverse classification within a reasonable time frame or resign from the board. In the event a principal stockholder or an officer who is not a director is involved in an adversely classified loan or other transaction, the board should be urged to assume special oversight over the loan or activity, either directly or through a committee of outside directors, with a view towards limiting any further exposure and moving aggressively to secure or collect any exposed balances as the circumstances may permit. There should be concern that these types of situations not only tend to compromise the credit standards of the lending institution and eventually may lead to losses but that they can also lead to violations of civil and criminal laws.

Nonbanking Activities Conducted on Bank Premises

Many banks conduct nonbanking activities on bank premises by selling insurance (e.g. credit life, accident and health) in conjunction with loan transactions of the bank. When these nontraditional banking activities take the form of establishment of a new department or subsidiary of the bank, the benefit and profit inures directly to the bank and its shareholders. However, when these activities are conducted on bank premises for the benefit of others, a bank may be deprived of corporate opportunity and profit. The FDIC has long taken the position that when nonbanking activities are conducted on bank premises either by bank personnel or others and when the benefit and profit does not flow directly to the bank, certain disclosures, approvals, and reimbursements must be made.

In all cases, the bank's directors and shareholders should be fully informed regarding the activity. The operation should be approved by the bank's shareholders, and expenses incurred by the bank in connection with these operations formally approved by the board of directors annually. The bank should be adequately compensated for any expenses it incurs in furnishing personnel, equipment, space, etc. to this activity. It is recommended bank management disclose completely to its bonding company any such nonbanking activity conducted on its premises.

Management would also be well advised to obtain acknowledgment from the bonding company that such activities do not impair coverage under the fidelity bond. Finally, the conduct of nonbanking activity must be in conformance with applicable state statutes and regulations.

Situations where the bank is being deprived of corporate opportunity through the diversion of opportunity or profit, or inadequately compensated for the utilization of its resources should be discussed with bank management and commented upon in the Management/Administration schedule and in the Examination Conclusions and Comments schedule if appropriate. Additionally, the absence of disclosure and approval to the bank's directors, shareholders, and bonding company should be discussed with management and covered in the aforementioned schedule. Finally, in those instances where the examiner believes, based on known facts, that a violation of applicable statutes or regulations has occurred, or where there is no question that a criminal violation has been committed, the matter should be handled in the usual manner as prescribed in other sections of the Manual.

Directors of "One Man Banks" and Advisory Directors

Supervisory authorities are properly concerned about the "One Man Bank" wherein the institution's principal officer and stockholder dominates virtually all phases of the bank's policies and operations. Often this situation stems from the personality make-up of the principal officer or ownership control, and it is usually abetted by an apathetic board of directors. Many bank directors when first elected have little or no technical knowledge of banking and feel dependent upon others more knowledgeable in banking matters. When this feeling becomes deep-seated and widespread, a managerial vacuum is created which an overly aggressive officer may fill and thus achieve a position of dominance. This development is facilitated by the fact that directors are very often nominated by bank officers to whom they feel indebted for the honor, even though stockholders elect them. Over the years, an officer can influence the election of a sufficient number of directors so that the officer is ultimately able to dominate the board and the affairs of the bank.

There are at least two potential dangers inherent in a "One Man Bank" situation. First, incapacitation of the dominant officer may deprive the bank of competent management, and because of the immediate need to fill the managerial void, may render the bank vulnerable to dishonest or incompetent replacement leadership. Second, problem cases resulting from mismanagement of such a bank's affairs are more difficult to solve through the normal course of supervisory efforts designed to induce corrective action by the bank.

A naturally sensitive situation develops where the value of a director diminishes due to extensive outside commitments, illness, etc. Often such individuals do not wish to relinquish their position and the bank may be hesitant to request they do so. Some banks have met this situation by establishing a position of honorary director (or similar title) for persons who are no longer able to effectively fulfill the demanding duties of bank director. Generally, the honorary director attends board meetings as desired and offers advice on a limited participation basis, but has no formal voice or vote in proceedings, nor the responsibilities or liabilities of the office, except where there may be a continuing connection with a previous breach of duty as an official director.

V. APPRAISAL OF MANAGEMENT

Although the directorate is an indispensable part of management of a bank, the overall appraisal of management must include an accurate review and evaluation of the competency of the day-to- day management team. Information obtained by examiners from appraisal of the directorate's policies and procedures must be combined with the appraisal of executive officers in determining the overall quality of the bank's management.

In reviewing executive officers' performance, examiners need to determine that:

1. Objectives, policies and procedures in the various asset, liability and operational areas are consistent,

2. Policies are being amplified and adhered to throughout the system,

3. Systems have been established to facilitate

efficient operation and communications,

4. The institution has developed planning processes which facilitate achievement of goals and objectives,

5. That daily management has the experience and depth to make sound decisions and assure continuity of operations, and

6. That management is capable of handling situations the institution might reasonably be expected to encounter in the future.

A bank's performance with respect to asset quality and diversification, capital adequacy, earnings capacity and trends, and liquidity and funds management is, to a very significant extent, a result of decisions made by the bank's directors and officers. Consequently, examiners' findings and conclusions in regard to the other four elements of the CAMEL rating system are often major determinants of the management rating. However, while a bank's overall present condition can be an indicator of management's past effectiveness, it should not be the sole factor relied upon in rating management. This is particularly true when there is new management or when the bank's condition has been significantly affected by external factors versus internal decisions.

When significant problems exist in a bank's overall condition, consideration must be given to management's degree of responsibility. However, appropriate recognition should also be given to the extent to which a bank's weaknesses are caused by external problems (such as a severely depressed local economy). A distinction should be made between problems caused by bank management and those largely due to outside influences. Management of a bank whose problems are related to the economy would warrant a higher rating than management believed substantially responsible for a bank's problems, provided that prudent planning and policies are in place and management is pursuing realistic resolution of the problems. Management's ability becomes more critical in problem situations, and it is important to note management's policies and acts of omission or commission in addressing problems.

The extent to which mismanagement has contributed to areas of weakness is particularly relevant to the management evaluation. Similarly, positive economic conditions may serve to enhance a bank's condition despite weak or undocumented policies and practices. At a minimum, the assessment of management should include the following considerations:

1. Whether or not insider abuse is in evidence;

2. Existing management's past record of performance in guiding the bank;

3. Whether loan losses and other weaknesses are recognized in a timely manner;

4. Past compliance with supervisory agreements, commitments, orders, etc.; and

5. Capability of management to develop and implement acceptable plans for problem resolution.

Assessment of new management, especially in a problem situation, is difficult. Performance by individuals at their former employment, if known to the examiner, may be helpful, but the examiner should assess each situation based on its particular circumstances. The management rating should generally be consistent with any recommended supervisory actions. A narrative statement supporting the management rating and reconciling any apparent discrepancies between the assigned rating and any recommended supervisory actions (or lack of recommended actions) should be included on Page A of the examination report.

Uniform Interagency Bank Rating System

The Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency have adopted for supervisory purposes a uniform interagency system for rating the condition and soundness of the nation's banks. The uniform bank rating system involves an assessment of five critical aspects of a bank's condition and operations. Management and administration is one of those critical dimensions.

Management's performance must be evaluated against virtually all factors considered necessary to operate the bank within accepted banking practices and in a safe and sound manner. Thus, management is rated "1" through "5" with respect to: technical competence, leadership and administrative ability; compliance with banking regulations and statutes; ability to plan and respond to changing circumstances; adequacy of and compliance with internal policies; depth and succession; tendencies toward self-dealing; and demonstrated willingness to serve the legitimate banking needs of the community.

A rating of "1" is indicative of management that is fully effective with respect to almost all factors and exhibits a responsiveness and ability to cope successfully with existing and foreseeable problems that may arise in the conduct of the bank's affairs. A rating of "2" reflects some deficiencies but generally indicates a satisfactory record of performance in light of the bank's particular circumstances. A rating of "3" reflects performance that is lacking in some measure of competence desirable to meet responsibilities of the situation in which management is found. Either it is characterized by modest talent when above-average abilities are called for, or is distinctly below average for the type and size of bank within which it operates. Thus, its responsiveness or ability to correct less than satisfactory conditions may be lacking. A rating of "4" is indicative of management that is generally inferior in ability compared to the responsibilities with which it is charged. Finally, a rating of "5" is applicable in those instances where incompetence has been demonstrated. In these cases, problems resulting from management weakness are of such severity that management must be strengthened or replaced before sound conditions can be brought about.

VI. MEETINGS WITH BANK DIRECTORS

In order to encourage director involvement in and enhance director awareness of the FDIC's supervisory efforts and to increase the effectiveness of such efforts, policies have been established governing meetings with bank boards of directors. The bank's composite rating is the single most important variable in the decision as to if and when these meetings should be held. Specifics of the Division's policies are detailed below.

Banks Assigned or Likely to be Assigned a Composite "4" or "5" Rating - The examiner-in-charge and the Regional Director or designee should meet with the board of directors (with the required quorum in attendance) during or subsequent to the examination. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the Regional Director's discretion.

Banks Assigned or Likely to be Assigned a Composite "3" Rating - The examiner-in-charge should meet with the board (with the required quorum in attendance) during or subsequent to the examination. Regional Office representation is at the discretion of the Regional Director. Additional meetings or other contacts with the board of directors or appropriate board committee may be scheduled at the discretion of the Regional Director or designee.

Banks Assigned or Likely to be Assigned a Composite Rating of "1" or "2" - The examiner-in-charge will meet with the board or a board committee during or subsequent to the examination when: 36 months or more have elapsed since the last such meeting; the management component of the CAMEL rating is "3", "4" or "5"; any other CAMEL performance rating is "4" or "5"; or any two performance ratings are "3", "4" or "5". It is important to note that meeting with a board committee (in lieu of the entire board) in conjunction with an examination is permissible only when the committee is influential as to policy, meets regularly, contains reasonable outside director representation and reports regularly to the entire board. Other factors which may be relevant to the decision of whether or not to hold a board meeting include recent changes in control ownership and/or top management, economic conditions, request by management for a meeting and any unique conditions or trends pertinent to the institution. Regional Office participation in meetings with composite-rated "1" or "2" banks is at the Regional Director's discretion.

Other Considerations - When a meeting is held in conjunction with an examination, the names of board and/or committee members in attendance should be included on the Examination Conclusions and Comments schedule. A clear but concise presentation of the items covered at the meeting, including corrective commitments and/or reactions of management, should also be

indicated. If the meeting is held, but not in conjunction with an examination, a summary of the meeting should be prepared and a copy mailed to the institution, via certified mail, for consideration by the board and inclusion in the official minutes of the directorate's next meeting. As above, this meeting summary should include the names of attendees and the corrective commitments and/or reactions of management.

When it is concluded a meeting with a board committee rather than the full board is appropriate, selection of the committee must be based on the group's actual responsibilities and functions rather than its title. In all cases, the committee chosen should include an acceptable representation of board members who are not full time officers.

The success of the board meeting is highly dependent upon the examiner's preparation. A written agenda which lists all areas to be discussed and provides supporting documents or schedules will usually be worthwhile as a means of assisting in the explanation of certain aspects of the examination. Failure to adequately prepare for the meeting may substantially diminish the supervisory value of the examination.

To encourage awareness and participation on the part of board members, examiners should inform bank management that the examination report (or copies thereof) should be made available to each director for thorough and timely review and that a signature page is included in the examination report to be signed by each director after review of the report. **Management should also be reminded the report is confidential, remains the property of the FDIC, and that utmost care should be exercised in its reproduction and distribution. The bank should be advised to retrieve, destroy and record the fact of destruction of any reproduced copies when they have served their purpose.**